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Good-Bye to the Washington Consensus?

JAMES E. MAHON, JR.

A certain gloominess has spread across Latin America. Argentina has fallen into the deepest economic slump in its modern history, with a poverty rate now surpassing 50 percent and an overwhelming popular repudiation of the country's political class. Venezuela seems to be slipping into civil war. The moment prompts dire observations. In *The New York Times*, columnist Nicholas Kristof asks if South America is the next Africa; "our neighborhood," he says, "risks falling apart." For United Press International's Ian Campbell, Latin America's "torment is not over and may get worse." Ricardo Infante, an analyst in the South American division of the International Labor Organization, describes a "social time bomb" in the region. Many observers, pointing to President Hugo Chávez in Venezuela, the recent election of Lucio Gutiérrez in Ecuador, the halted privatizations in Peru and Bolivia, and the presidential triumph in Brazil, after three failed attempts, of Luiz Inácio Lula da Silva, have pronounced that Latin America is moving to the left—or ought to do so soon.

The problem with this assessment is that it has been made before: repeatedly, and wrongly. Looking at South America in 1983, in the middle of the debt crisis, it was easy to predict a rise in organized class conflict and maybe the arrival of a few more pro-Cuban regimes. Instead we saw the spread of electoral democracy. After the elections between 1988 and 1990 of Carlos Andrés Pérez in Venezuela, Carlos Saúl Menem in Argentina, and Alberto Fujimori in Peru, all of whom ran populist campaigns, a new outbreak of economic heterodoxy was predicted. Instead, all three spun to the right and joined the parade of market-oriented economic reform. Today, Chile's socialist president, Ricardo Lagos, has concluded a free-trade agreement with the United States; in Ecuador, Gutiérrez, who as an army colonel in January 2000 had joined arms with leaders of the country's largest indigenous organization in a coup (while excoriating greedy bankers), wants a new agreement with the International Monetary Fund; and Lula himself, having taken office amid financial turmoil, has calmed the markets with reassuring words, economically orthodox cabinet appointments, and an investor-friendly trip to the United States.

What, if anything, makes this moment different? First, external trends have turned negative. World economic conditions have become more uncertain, credit flows to Latin America have slowed to a trickle, and we have seen an apparent rise in protectionism by the North. Second, many of Latin America's social and economic problems are worse. Crime, unemployment, and inequality, which had already risen in the 1980s, have brought increasing popular frustration with ineffective governments. Latin Americans might have expected, after following the free-market economic policies of the "Washington consensus" for a dozen years, that the region would have begun to savor the fruits of openness. But with some exceptions—notably Chile, Costa Rica, and much of Mexico—the fruit has turned out to be bitter, as economic openness appears to have accelerated social disintegration.

THE SKITTISH INVESTOR

One lesson from the great twentieth-century shifts in Latin America's economic orientation is that external forces matter considerably. Import-substituting industrialization—based on the erection of high trade barriers to protect domestic industries—began as a necessity, prompted by the

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Great Depression and World War II, and only later became a deliberate strategy. Except in Chile, the neoliberalism of the Washington consensus was born of the regional debt crisis. Only after they failed to form a debtors' cartel, discovered that nationalizing banks or printing money did not work, and received a strong push from the United States and the international financial institutions, did Latin American governments embrace market-friendly policies with apparent conviction. The next watershed is likely to look similar.

The embrace of neoliberalism has not brought economic disaster to Latin America, but the full picture is mixed and recent trends are mostly negative. Economic growth was faster in the 1990s than in the 1980s (which is not saying much), but it slowed abruptly in 1995 and 1998 and has decelerated steadily since late 1999. According to figures from the UN Economic Commission for Latin America and the Caribbean (ECLAC), real wages in 2001 stood above 1990 levels in 12 of 14 major countries, and above those of 1980 in nine of them. During the 1990s, urban unemployment fell in five countries and rose in ten (most alarmingly in Argentina and Colombia). Income distribution grew worse in most countries (although by one measure—the participation of the poorest 40 percent of urban households in total income—it had improved in the majority of countries as of 2000). But these figures predate Argentina's financial collapse and the deepening of recession in Venezuela. Preliminary World Bank figures for 2002 show a drop of 1.1 percent in Latin America's GDP. In per capita terms this equals a 2.6 percent fall, the second successive year of decline and the worst year since the debt crisis in the 1980s.

Over the past ten years, every economic slump in Latin America could be easily connected to a financial crisis in some "emerging market." In the 1990s the entire region suffered the "tequila" effect from Mexico's peso devaluation (1994–1995) and later a panic induced by Russia's bond default (1998–1999). Following this pattern, most observers have ascribed the contraction of 2001 and 2002 to Argentina's default on its foreign debt and to investors' worries about Brazil's Lula.

But a closer look at the data suggests that the last two events are part of a longer-term pattern: a reversal of net capital flows. Data from the Institute for International Finance show that the sum of net portfolio flows (equity and bonds) and net commercial bank lending to Latin America was negative in 1999, 2001, and 2002. Strong direct investment flows kept the net amount of private external financing positive, but decreasingly so—from $71 billion in 1999 to an estimated $29 billion in 2002. If we consider ECLAC figures that look more broadly at the capital accounts of Latin American countries, we find that the region has generally had a net outward transfer of resources from 1999 onward. By this measure, the net outflow was $39 billion in 2002, driven by capital flight from Argentina, Brazil, and Venezuela.

Insofar as the reversal of net capital flows was due to systemic problems, these were mostly to be found outside Latin America. The region's burden of foreign debt, at least in the aggregate, has not suddenly become unsustainable. Since 1990 external debt has remained relatively stable as a proportion of GDP, while generally declining as a proportion of exports (a trend that was interrupted only in 1998). The borrowers have also become less public and more private: according to the World Bank, public debt fell from 93 percent of all long-term foreign debt in 1990 to 63 percent in 2001. It grew 17 percent over those 11 years, while private debt grew 872 percent.

Granted, the aggregate figures miss important individual variations. They do not count Brazil's massive internal obligations, a sign of its financial strength (few emerging markets sell as much domestically) as well as fragility (average bond maturity is still less than two years). And Argentina's foreign-debt-to-export ratio climbed well above twice the regional average before its default. On the positive side, Chile and now Mexico issue sovereign bonds that are rated investment grade.

THE WASHINGTON CONSENSUS

THE POLICY, in rough order of "consensus":

1. Limit fiscal deficits to what can be financed (voluntarily) in bond markets.
2. Maintain an independent central bank and market-determined interest rates.
3. Welcome foreign direct investment.
4. Liberalize trade.
5. Develop local bond and stock markets.
6. Privatize state companies, especially those losing money.
7. Reform taxation, making the value-added tax the main source of revenue.
8. Let markets set the exchange rate (floating) or dollarize (the Argentine collapse has reinforced the perception that policies between these two extremes are not feasible).
9. Liberalize capital movements. *J.M.*

Latin America and the Caribbean: Net Resource Transfers

(Millions of dollars)

Country	1993	1994	1995	1996	1997	1998	1999	2000	2001*
Argentina	9,349	8,107	354	5,072	9,138	10,449	5,767	1,829	-13,099
Bolivia	200	46	251	459	433	648	324	199	43
Brazil	-1,633	-723	19,951	19,743	6,242	7,497	-1,273	4,490	7,965
Chile	1,071	2,004	-625	1,952	4,176	29	-2,551	-1,181	-1,895
Colombia	784	2,369	3,028	4,408	3,767	2,055	-2,158	-2,013	-340
Costa Rica	464	273	355	27	301	-100	-645	-656	79
Dominican Republic	-9	-785	-455	-528	-593	-455	-352	-84	965
Ecuador	-89	116	-685	-1,185	-375	231	-2,713	-2,263	-567
El Salvador	118	36	338	243	179	321	165	103	107
Guatemala	704	599	210	356	716	1,101	709	1,355	1,206
Haiti	54	-15	168	-14	114	-35	1	7	87
Honduras	-4	151	50	110	260	64	509	178	225
Mexico	18,427	-1,748	-2,065	-9,336	5,174	4,599	1,661	6,496	10,048
Nicaragua	359	511	426	598	835	597	1,051	702	453
Panama	-97	-132	81	282	802	517	749	212	-422
Paraguay	84	735	262	423	-75	85	220	144	13
Peru	1,343	3,827	3,236	3,916	3,540	1,141	-502	-140	76
Uruguay	231	293	203	185	485	798	391	627	514
Venezuela	134	-5,610	-5848	-4,076	-2,797	-2,377	-4,484	-9,001	-8,850
Latin America	31,490	10,054	19,235	22,635	32,322	27,165	-3,131	1,003	-3,393

Source: UN Economic Commission for Latin America and the Caribbean (ECLAC), on the basis of information supplied by the International Monetary Fund and by national institutions.
Notes: Negative figures indicate outward transfers of resources. Net resource transfers are equal to net capital inflows less the balance of income (net payments of profits and interest).
*Preliminary estimates.

As this suggests, the recent crisis has also seen less of the mindless financial contagion that was visible in 1994–1995 and 1998. The Argentine collapse was so clearly foreseen that it barely affected the markets in other Latin American bonds. Jitters about Brazil in mid-2002 did have a moderate effect on the rest of the region. But instead of undiscriminating financial markets, the most important vectors of contagion have been trade (Paraguay, Uruguay, and Bolivia), return migration and falling labor remittances (Paraguay and Bolivia), and bank runs (Uruguay).

The central problem is that falling United States and European stock markets have left rich-country investors more risk-averse. They discriminate more strongly among countries just as they discriminate more strongly (with larger interest-rate spreads) between riskier corporate bonds and treasury bonds in rich-country markets. According to JP Morgan, if we remove Argentina and Brazil, risk premia on Latin American bonds have followed the rising trends of United States corporate junk bonds, with Mexico and Chile paying less. Thus, while the midyear financial contagion was only moderate (and affected other regions not at all), combined with the new risk aversion, the contagion blocked borrowing by countries that did not enjoy an investment-grade bond rating, even if they were not suffering a crisis.

Moreover, as a recent IMF report observes, foreign direct investment "has in the past been correlated with [rich countries'] equity market performance." And with fewer privatization projects to carry out and political opposition to them rising, inflows of foreign direct investment might never again reach the record levels of 1999. Barring a sudden decision to privatize state-owned energy companies in Mexico or Venezuela, inflows will likely respond to political stability, economic recovery, and (as they did in 1999 in Brazil) the massive currency depreciation that makes assets look cheap to foreign buyers.

Most disturbing is that the new scarcity of external financing coincides with a greater need for it. Commodity prices fell steeply from November 1997 through mid-1999, and have stayed in a low range since. As the World Bank has noted, many products exported by Latin America (sugar, bananas, arabica coffee, aluminum) saw further price declines in

Latin America and the Caribbean: Total Disbursed External Debt
(Millions of dollars)

Country	1990	1993	1994	1995	1996	1997	1998	2000	2001*
Argentina	62,233	72,209	85,656	98,547	109,756	124,696	140,489	146,200	142,300
Bolivia[1]	3,768	3,777	4,216	4,523	4,366	4,234	4,655	4,461	4,465
Brazil	123,439	145,726	148,295	159,256	179,935	199,998	241,644	236,157	226,820
Chile	18,576	19,665	21,768	22,026	22,979	26,701	31,691	36,849	37,060
Colombia	17,848	18,908	21,855	24,928	29,513	32,036	35,696	35,851	38,170
Costa Rica	3,924	4,011	3,818	3,889	3,376	3,290	3,500	4,050	4,225
Cuba	---	8,785	9,083	10,504	10,465	10,146	11,200	11,100	11,100
Dominican Republic	4,499	4,563	3,946	3,999	3,807	3,572	3,537	3,676	3,800
Ecuador	12,222	13,631	14,589	13,934	14,586	15,099	16,400	13,564	13,440
El Salvador[1]	2,076	1,976	2,056	2,168	2,517	2,689	2,631	2,795	3,425
Guatemala	2,487	2,323	2,644	2,936	3,033	3,210	3,619	3,929	3,900
Guyana	1,812	2,062	2,004	2,058	1,537	1,514	1,500	1,250	1,250
Haiti[1]	841	866	875	902	914	1,025	1,100	1,170	1,190
Honduras	3,588	3,850	4,040	4,242	4,121	4,062	4,404	4,685	4,650
Jamaica	4,152	3,687	3,652	3,452	3,232	3,278	3,300	3,200	3,200
Mexico[2]	101,900	130,524	139,818	165,600	157,200	149,000	161,300	149,300	146,100
Nicaragua[1]	10,616	11,987	11,695	10,248	6,094	6,001	6,287	6,660	6,340
Panama[2]	3,795	3,494	3,663	3,938	5,069	5,051	5,180	5,604	6,330
Paraguay	1,670	1,254	1,271	1,439	1,434	1,473	1,599	2,491	2,450
Peru	19,996	27,489	30,392	33,515	33,805	28,508	29,477	28,353	28,240
Trinidad and Tobago	2,520	2,102	2,064	1,905	1,876	1,541	1,430	1,550	1,550
Uruguay	4,472	3,578	4,251	4,426	4,682	4,754	5,195	5,492	5,800
Venezuela	36,615	40,836	41,179	38,484	34,222	31,212	29,526	31,545	30,000
Latin America	443,049	527,303	562,830	616,919	638,519	663,090	745,360	739,930	725,805

Source: UN Economic Commission for Latin America and the Caribbean (ECLAC), on the basis of information supplied by the International Monetary Fund and by national institutions.
Note: Includes public- and private-sector external debt. Also includes International Monetary Fund loans.
*Preliminary figures.
[1]Public external debt.
[2]Public debt does not include investments made in government securities by nonresidents.

2002. Along with the Argentine catastrophe, this further depressed economic growth in the region. Declining output, in turn, led to falling fiscal revenues and helped push the region's estimated budget deficits to 2.6 percent of GDP, up from 1.8 percent in 2000 and 2001. This is not to exonerate the poor fiscal management in many countries. It is to point out that at a moment when Latin American governments need external financing to fight recession, the same recession has aggravated fiscal problems—and, it is reasonable to expect, political uncertainty—that could further discourage risk-averse foreign investors.

THE FALLOUT: SOCIAL DISINTEGRATION

We have not yet seen a popular rejection of neoliberalism. Voters still reward leaders who keep inflation low, so it is now the rare president who pays for fiscal deficits by printing money. Most governments still actively welcome foreign investment and trade. But according to Latinobarómetro's 2002 poll, across the region only 35 percent of the people (compared with 51 percent in 1998) said that the state should leave economic activity to the private sector. Most respondents also opposed privatizations. Still, their shift seems to bespeak anxiety rather than rebellion: in terms of the average respondent's self-described politics, the same poll showed that 11 countries moved right and only 2 (Argentina and Peru) moved left between 1996 and 2002.

Behind the anxiety lies social disintegration. The homicide rate in Latin America is now the highest of any region in the world. Although figures vary widely across countries (with Colombia, Guatemala, El Salvador, and Brazil setting the grim pace), the rate increased from about 8 per 100,000 in the 1970s to about 13 in the 1990s, according to the Interamerican Development Bank. (The United States rate was 5.6 in 2001.) Meanwhile, the young and educated are leaving. Emigration has risen most distressingly in Argentina, Colombia, and Venezuela, and is increasing across most of the region. Although spurred by crime and civil conflict in some places, the basic motivation has been economic—specifically, the mismatch between education systems that turn out large numbers of aspiring professionals and the economies that cannot employ them. As a result, many of the same kind of people who once hoped to prosper in market-friendly economies at home are now entering the market elsewhere.

The old party systems are also decomposing. As democracy spread in the 1980s and traditional political parties reentered the arena, most followed their old reflexes, building support through forms of patronage. In addition to the familiar dispensation of state jobs to party regulars, they had also granted favored status to party-linked labor unions and, in some countries, peasant organizations. After 1980, however, economic crises, neoliberal reform, and urbanization greatly weakened the last two and narrowed the scope of the first. Also, once-loyal partisan voters grew disenchanted when, under the pressure of financial circumstances, leaders elected as populists governed as neoliberals. As "schools" for politics, unions and parties have increasingly given way to neighborhood associations, evangelical Protestant churches, and television.

As Latin American societies have changed, so have the region's dominant political issues. Depending on the estimate and the country, between 33 and 60 percent of all economically active Latin Americans work in the urban informal sector at such jobs as street vendors, day laborers, and maids. Not tied to the fraying networks of patronage, they tend to distrust or resent political parties. Their key political concerns revolve around the home and the street rather than the workplace. While they deeply resent the privatizations and bank bailouts that have favored the rich and well connected at the expense of the rest, they look to the state first for public security, functioning schools, monetary stability, and affordable prices for the utilities that allow a decent urban life.

Into this void have stepped new plebiscitarian antiparty movements, often headed by former military men. Consider the similarities of Venezuela's Chávez, Ecuador's Gutiérrez, and Lino Oviedo (Paraguay's most popular politician, now in exile in Brazil). Each led an unsuccessful coup attempt and later ran for office as a civilian. Their supporters see coup making not as a disqualification but as a testament to their "manly" transcendence of shady partisanship. Each man rose to power at a time when his country's political parties, although still powerful in the legislature, had public approval ratings among the lowest in the region. (According to Latinobarómetro's measure of those registering "a lot" and "some" confidence in parties, Venezuela in 1996 scored 11 percent; Ecuador in 2002, 7 percent; and Paraguay in 2002, 7 percent.) Also compared to others in the region, these parties were known for their unusual devotion to patronage. And all three movements had similar social contexts. According to ECLAC figures, by the end of the 1990s over half the urban population in these three countries was employed in the informal sector, proportions that were among the highest in the region (exceeded only by Peru, Bolivia, and Nicaragua). In Venezuela's case, this sector grew more rapidly in the decade (from 39.2 percent in 1990 to 53.7 percent in 1999) than it did in any other country.

As more Latin Americans struggle in the most unforgiving realms of market society, more also feel alienated from the existing institutions of democracy. They are poor and have seen a few others grow rich—often, they believe, through graft, fraud, or drug trafficking. They fear disorder and, since most now reside in sprawling cities, they care most immediately about the kind of public housekeeping issues that typically land on the desks of big-city mayors. (Examples of effective and popular municipal government—Bogotá, Curitiba, Mexico City—have been a source of hope.) They are ready to welcome earnest, once-uniformed leaders who promise to take partisanship out of administration and to punish the corrupt.

This does not amount to a rebellion against neoliberalism. Yet when parties weaken and large electoral movements coalesce quickly around charismatic heroes, politics becomes even more unpredictable. While this worries foreign investors in Latin America, global trends might continue to discourage them more.

THE SELF-CORRECTING WASHINGTON CONSENSUS?

Can Washington turn these trends around? The first challenge is trade. As capital flows to Latin America diminish and fiscal austerity weighs on domestic markets, the region will have to export more. In theory, this prospect ought to generate sincere Latin enthusiasm for the proposed Free Trade Area of the Americas. But the Bush administration must overcome its own lack of credibility when it comes to freeing trade and ending subsidies in areas Latin Americans care about, such as steel or agriculture. The European Union has behaved no better. And if the United States and Europe fall back into recession, trade liberalization is likely to slip off the agenda.

Finance is equally sticky and of more immediate importance. In mid-2002, as economic jitters spread north and east from Argentina, the international financial institutions, led by the IMF, stepped in with major countercyclical packages for Brazil and Uruguay. But the story has been different in Argentina. There the fund, already highly exposed from previous loans and still smarting from its manipulation by then Economy Minister Domingo Cavallo in August 2001, has acted more like a commercial creditor. For the Peronists' undeniable sins—above all, making insolvent many local affiliates of international banks by converting their loans and deposits to pesos at different rates—it has imposed a heavy penance: the IMF has required Eduardo Duhalde's government to demonstrate credibility in its fiscal austerity efforts while in the midst of a devastating economic depression.

One important difference between today and 1990 is that nothing like a Brady Plan is in the wings (the United States–initiated Brady Plan promised a negotiated debt-service reduction in exchange for liberalization and privatization). Why not? First, most of the liberalization is done and, as was noted, fewer economic activities are left to privatize. Second, since much of the debt now takes the form of bonds (issued to a wide variety of private companies as well as governments), and existing bond contracts generally require unanimous assent of the bondholders to any changes, a consensual restructuring cannot take place as easily as bank debt renegotiation. Argentina's debt default, for example, involved some 82 contracts.

Current reform proposals suffer from weak support, limited coverage, and bad timing. The IMF favors a kind of international bankruptcy court (the Sovereign Debt Restructuring Mechanism) to handle government bonds, yet the proposal has generated strenuous opposition from private financiers, including a former managing director of the fund itself. The reform most likely to pass—the incorporation of collective-action clauses in bond contracts that would allow a supermajority to approve restructuring—would apply only to newly issued debt. To ease the reduction of debt service, old bonds would have to be swapped in the market for new. But debtors (especially those enjoying an investment-grade rating) fear that the clauses would mean worse borrowing terms, which would raise their debt-service costs in the short run. Financiers claim that the entire discussion is spooking the markets at the wrong time. Apparently, the absence of rampant contagion like that seen in 1995 makes systemic reform less likely.

This suggests that major relief is not in the cards for 2003. In the late 1980s, during discussions on the Brady Plan, persuading commercial banks of the virtues of a 35 percent reduction of loan principal was relatively easy because they were selling many of their Latin American loans in the secondary market at a discount twice that size. Regionwide bond-market declines of a similar magnitude today would be devastating, in part because Latin American economies are now more tightly integrated with international finance. The problem is how to engage in orderly debt restructurings without provoking a deeper crisis.

FAITH, HOPE, AND CREDIT

Despite the recovery of Brazil's financial markets in the months after Lula's victory, it can be said that capital punished the country heavily for electing a leftist. In the middle of the storm, a few United States commentators darkly warned of Lula's friendship with Fidel Castro and Venezuela's Chávez as evidence of a crumbling southern front in the war on terrorism. Yet this "enemy" proceeded to calm the markets by agreeing to a large fiscal surplus in 2003, impressing bankers with his cooperativeness. Had Lula not done so, investor wariness would have turned into a true panic, leading to a self-fulfilling financial explosion. But it was bad enough. By year's end, stock market and bond country-risk indices for Brazil had returned to June levels (leaving the latter still almost twice as high as it was in March), and the rise in interest rates over the interim put an added debt burden on the new government, while depressing the rest of the economy.

As Lula now tries to manage financial fragility, many details of his strategy should sound familiar to Latin American presidents who have had to deal with financial stress. First, obtain credit from the IMF, contingent on promises of fiscal austerity, and thereby calm the bond markets further so that the federal government can handle a daunting schedule of domestic debt rollovers in the middle months of 2003. This will reduce interest rates, which should keep economic activity from falling more than a percentage point or two for the year. Next, before the honeymoon ends, use the crisis atmosphere to reform taxes and a pension system that bleeds red ink as it rewards the well connected. Perhaps by the second full year, having displayed fiscal rectitude and maybe enjoying a revived economy, turn to the task of adjusting federal spending priorities to more closely accord with those of the party.

All this sounds like a fiscally sound route to social democracy. And Lula might even navigate it successfully—if the legislature cooperates, the public-sector pension beneficiaries go quietly, the public remains patient, and the markets rebound. But he also has to worry that, in tacking to the center, he could end up viewed as yet another faithless Latin American politician who sacrificed his ideals on the altar of the bond market.

What else might the affected governments do to help end the slump? As in Brazil, fiscal decisions will take center stage. Governments will have to tax more effectively, cracking down on evasion (especially by the richest), but without putting a brake on economic growth. They will need to resist the temptation to privatize in the sole pursuit of revenue, as many did in the early 1990s. Because this entailed granting weakly regulated private monopolies (so as to maximize the purchase price), it made such sales unpopular. In the long run, governments should recognize that the Washington consensus works better as a guide to macroeconomic management than as a development strategy. In the short run, they might begin to negotiate debt restructuring.

But why can they not just quietly default? At this time, most Latin American leaders would lose much more from defaulting on their bonds than they would gain. Even if partial and nonconflictual, a default would push interest rates to punishing levels while making trade finance more expensive. True, it would free up government spending, but in countries where the fiscal deficit exceeds interest payments, it would not eliminate the need to borrow. Thus, the damage would be immediate and severe, while the benefit would come later, its size and shape determined by the government. But if commodity prices stay low, if rich countries continue to close important markets, and above all, if the financial flows continue to remain weak, Latin American governments will reevaluate their choices. Obviously, the argument that they must repay promptly and fully to preserve their access to international capital markets will become less persuasive if, for these borrowers at least, the markets have no capital.

When Lula traveled to Washington on December 10, he had three priorities: “credit, credit, and credit.” We all ought to hope that he gets it. If he does not, and if the financial drought persists another year, the consequences are likely to displease Washington. ■